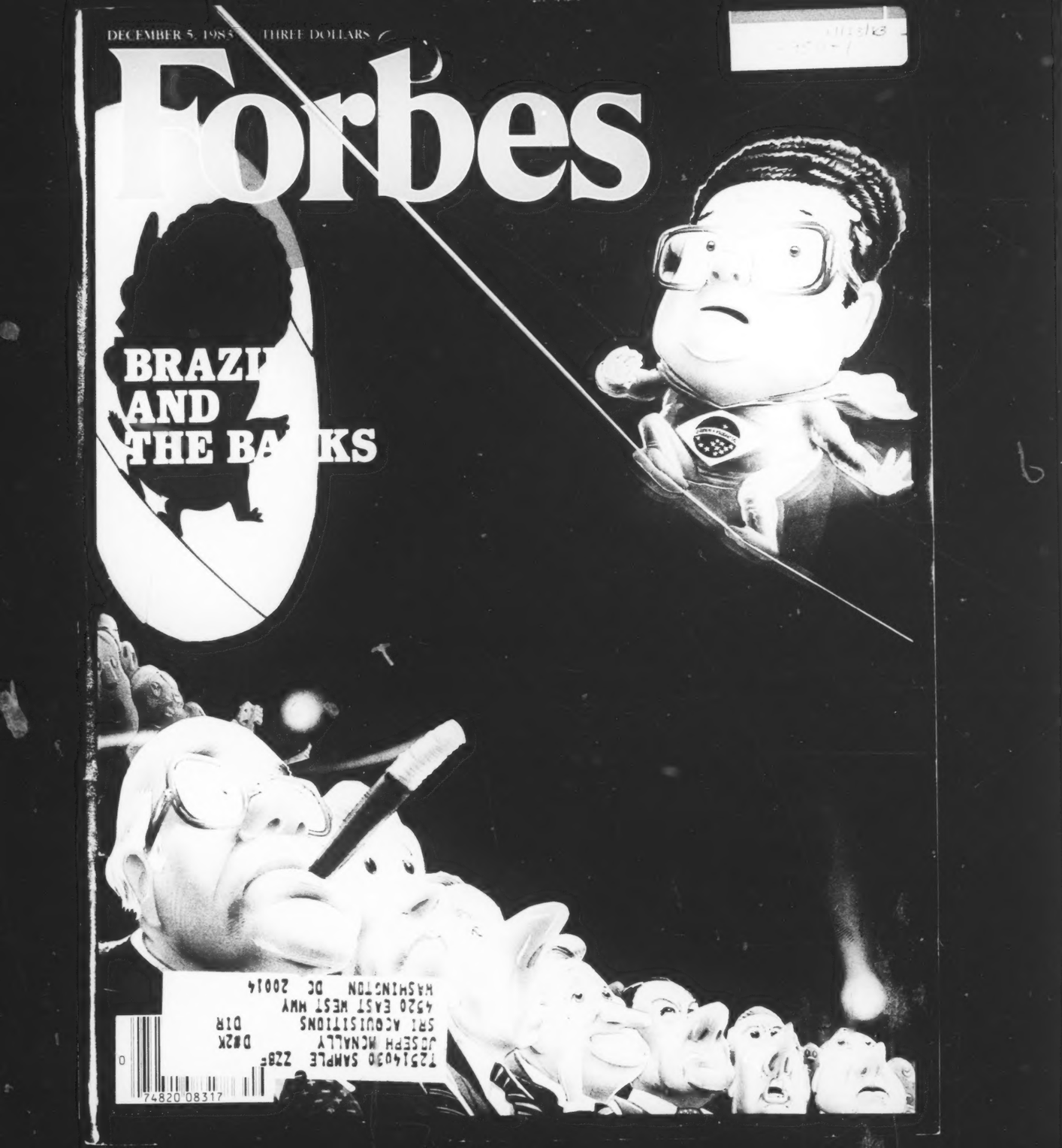

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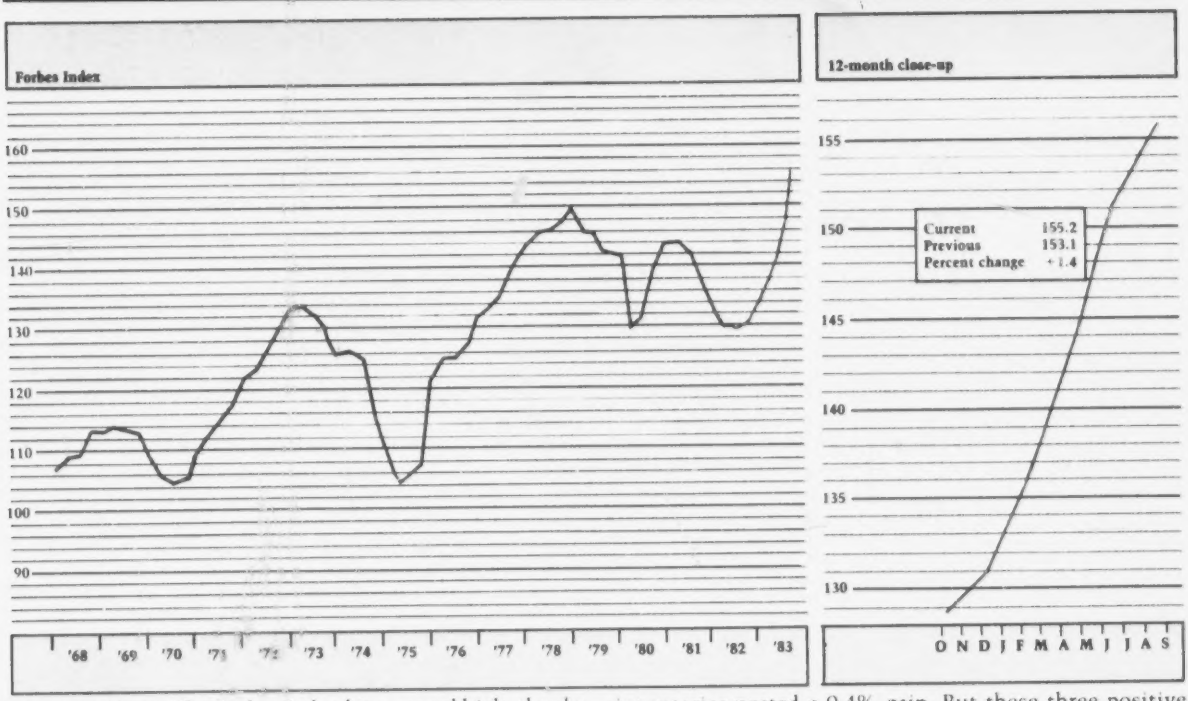
The Forbes Index



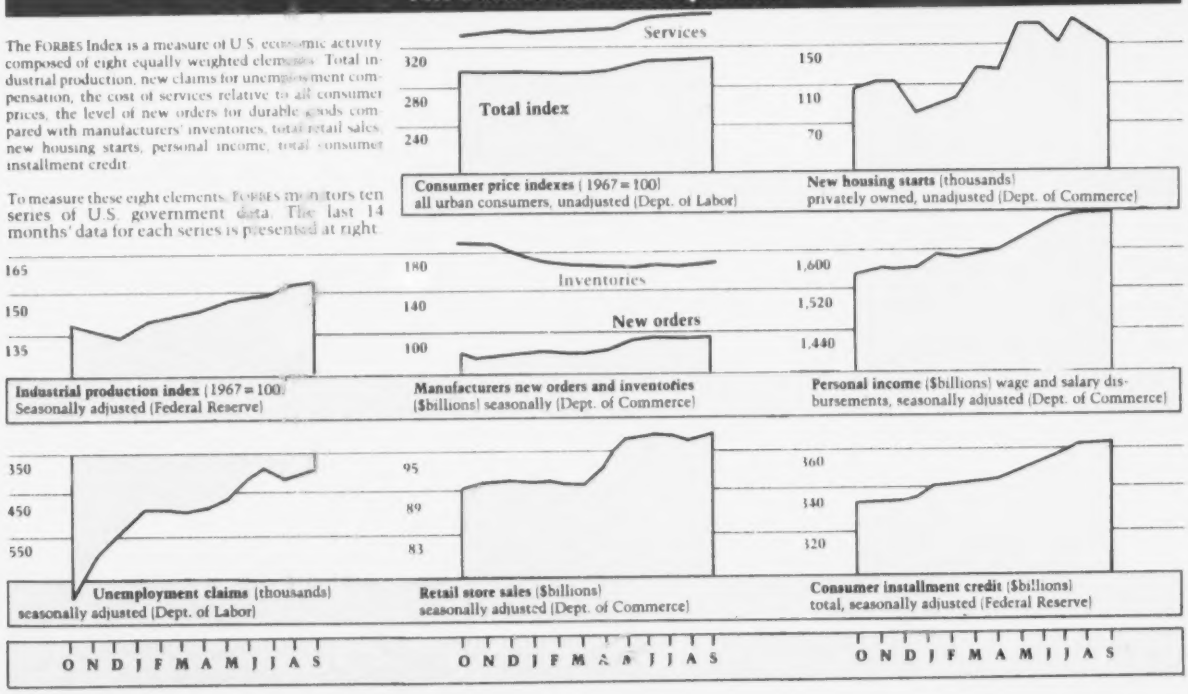
New territory. The Forbes Index hit a record high, thanks largely to the gains in new housing starts and the drop in unemployment claims. A 0.7% month-to-month jump in consumer installment credit—a sign that people may be borrowing and buying in force—gave the Index an upward nudge. In addition, inventories are 6.3% lower than they were at the same time last year. Manufacturers' new orders were up 1.1% from previously revised figures, and inventories posted a 0.4% gain. But these three positive signs weren't strong enough to pull up the Index, which uses them as part of a moving average.

Slight downward revisions of two previously reported components tempered the rise of the Index, too. Retail sales now show a 1.3% month-to-month gain. And the drop in new unemployment claims is only 5%, rather than the 5.4% that was reported earlier.

The Forbes Index Components

The FORBES Index is a measure of U.S. economic activity composed of eight equally weighted elements. Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series is presented at right.



Brazil can't pay the interest on its $90 billion debt. So why are bankers pretending that it can? They would be better off wiping the slate clean and starting over—next time more cautiously.

Games bankers play

By Norman Gall

DOES ANYBODY remember President Calvin Coolidge's annoyed response when he was told the British and French were suspending payments on the money they borrowed from the U.S. to fight World War I?

"They hired the money, didn't they?"

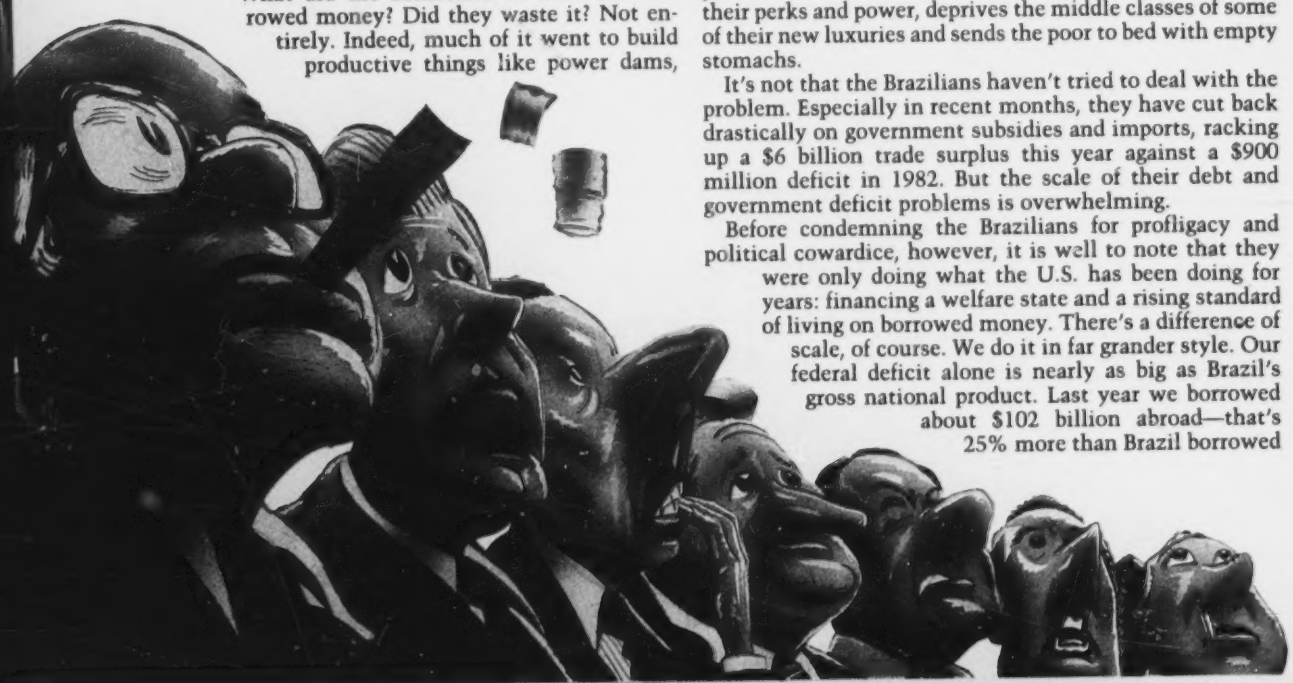
Oh, yes, they hired the money, but the proceeds were fired out the muzzles of cannons, and our old allies never paid most of it back. Nor will Brazil ever pay back at anything like 100 cents on the dollar, with interest, the $90-odd billion it owes to foreign banks, exporters and governments. Beyond that it is doubtful whether Brazil can honor its domestic government debt, which has trebled in the past year alone, swollen by—and contributing to—Brazil's runaway inflation.

What did the Brazilians do with the borrowed money? Did they waste it? Not entirely. Indeed, much of it went to build productive things like power dams, steel mills, ports, fertilizer factories, airports and a telecommunications network. Too much of it, however, went for things of little productive value. For example, vast handouts to the working class, to the middle class, to the wealthy. These handouts helped this nation of 126 million people accept two decades of unpopular military rule. But now the bill has come due.

And therein lies a major part of the international debt problem, involving $700 billion in loans and credits and the solvency of some major American banks: How do you pay interest on money, lots of money, money that has been eaten or spent on trips abroad or on expanding the bureaucracy? Only by asking people to eat less for a while, traveling abroad less and firing bureaucrats. Not easy. Not pleasant. It's the kind of medicine that costs politicians their perks and power, deprives the middle classes of some of their new luxuries and sends the poor to bed with empty stomachs.

It's not that the Brazilians haven't tried to deal with the problem. Especially in recent months, they have cut back drastically on government subsidies and imports, racking up a $6 billion trade surplus this year against a $900 million deficit in 1982. But the scale of their debt and government deficit problems is overwhelming.

Before condemning the Brazilians for profligacy and political cowardice, however, it is well to note that they were only doing what the U.S. has been doing for years: financing a welfare state and a rising standard of living on borrowed money. There's a difference of scale, of course. We do it in far grander style. Our federal deficit alone is nearly as big as Brazil's gross national product. Last year we borrowed about $102 billion abroad—that's 25% more than Brazil borrowed



over the past ten years.

So, why is Brazil suffering over 200% annual inflation and unable to pay its loans, while the U.S. in its worst year had only 13% inflation and has no trouble servicing its debts? Scale again. American profligacy is supported by a far bigger and stronger economy. But, in many senses, the two countries, indeed most countries today, are sisters and brothers under the skin. The details differ, but the plot is always the same. They call it populism and mortgage the future to pay for it. For Brazil today the mortgage is due, with repayment now accelerated by high interest rates. And there is nothing much to pay it with.

How did Brazil get in such a fix? It's an old story, well described in a League of Nations report on the great Central European inflations of the 1920s: "Inflation is the form of taxation which even the weakest government can enforce, when it can enforce nothing else."

That's the key to the Brazilian mess, indeed the whole international lending mess: Printing money to monetize debt is easy for any modern government. It enables a government to spend freely without seeming to tax. And the public will blame some mysterious force called "inflation" rather than government spending and credit creation itself.

Which helps explain, of course, why inflation and seeming prosperity so often go hand in hand. When U.S. inflation was beginning to slip out of control in 1979, the U.S. was wallowing in a consumption-oriented economic boom highlighted by a virtual orgy of home buying. In the midst of Brazil's spreading financial chaos, its real economy seems to be standing up surprisingly well.

As did Germany in the half-century before 1914, Brazil in the half-century through 1982 went through an extraordinary process of fast economic development, national unification and creation of a large middle class. In 1960 only 1 in 29 Brazilian families had a private car. By 1980 1 in every 4 families had one. All this was accompanied by a high rate of inflation and monumental borrowing abroad. Everybody sensed that inflation and foreign borrowing on that scale were dangerous, but nearly everybody seemed to be gaining from it.

The first oil crisis hit Brazil hard, but foreign loans enabled the Brazilians to pay their huge oil import bill without slowing economic growth. Thus its economy grew by 7% per annum from 1974 to 1980, while the economies of the industrial countries were languishing at 2.5% growth.

So, not all the borrowed money was wasted. Brazil's newly expanded steel industry, faced with reduced home demand, is making major gains in export markets. Farm production has been expanding steadily over the past four years, and, despite crop losses from this year's floods in southern Brazil, the export sector is gearing up for a windfall in soybean earnings (FORBES, *Aug. 30, 1982*), thanks to this year's drought in the U.S. Midwest. Tractor sales are booming as acreage expands into new frontier areas, and increased demand is creating shortages in machinery, seeds and fertilizer.

The crisis and the consequent tightening of the money supply has brought riots in big cities, but many provincial towns seem stable and prosperous. A gold rush in Amazonia has brought hundreds of thousands of men to dig and pan in jungle streams.

Near the gold rush country in the colonial port of São Luis at the edge of Amazonia, Alcoa is building a $1 billion alumina-aluminum complex, to be fed by the region's rich bauxite and hydropower resources. When it is finished next year the plant will become a principal supplier to the U.S. and thus a major source of foreign exchange.

Meanwhile, Brazil's oil production has more than doubled since 1979, to 340,000 barrels daily, with new offshore finds promising to raise output to perhaps 420,000 barrels next year. At the same time, expensive investments to replace gasoline with alcohol, distilled from sugarcane juice, have been bearing fruit. Today 92% of the cars rolling off Brazilian assembly lines run on alcohol.

Why do such economic growth, rising standard of living and rising inflation so often go hand in hand? No mystery: The very credit creation that leads to inflation also encourages enterprise, at least in the early stages, by making money plentiful and cheap in real terms.

Alas, however, the process is self-limiting, and the limits are at hand. In the end those debts that financed the easy expansion cannot all be paid. In Germany in the 1920s, the Weimar government's credit collapsed. Unable to borrow, the German government had to run the printing presses flat out. In Brazil today a similar collapse of public credit may be imminent.

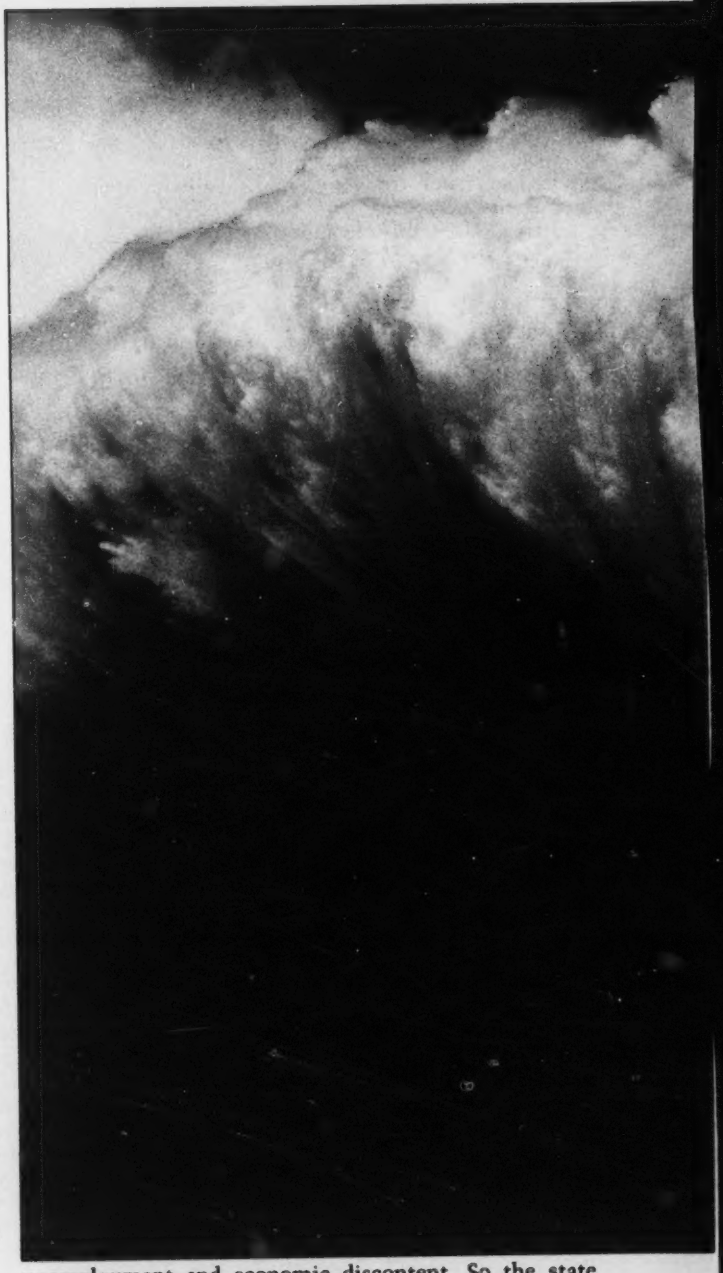
The precursor of this collapse is an almost tangible sense of fear. Says the editor of a leading Brazilian newspaper: "It will be like Germany in the 1920s. First, hyperinflation and social chaos, then a National Socialist regime to lead us out of the wilderness—into God knows what." A young secretary with an unemployed husband explains why the couple quit São Paulo for the remote countryside: "There's going to be an explosion. People can't live on what they earn." In an effort to make ends meet, both individuals and businesses are slipping into the underground economy at an accelerating pace. The result is further losses of government revenues and ability to borrow.

All this has begun to bleed resources away from Brazil's huge government-owned corporations, themselves an engine for inflation and for debt creation. These corporations, political entities as much as economic entities, flourished in Latin America in the postwar decades, nourished by foreign borrowing and printing-press money. These corporations created jobs and economic activity, but at the expense of ever-growing market restrictions and subsidies. The subsidies swelled the government deficit,

Antonio Delfim Netto
Brazil's Minister of Planning

while the market restrictions now saddle the Brazilian economy with high costs.

State capitalism is not a purely Brazilian or Latin American problem; in recent decades it has spread all over the world to countries as different as South Korea, the U.K. and South Africa. Americans who advocate an "industrial policy" to help our troubled automobile or steel industries would do well to see where this has led in Brazil.



The huge Itaipu Dam on the Paraná River

What did Brazilians do with the borrowed money? Did they waste it? Not entirely. Much of it went to build productive things like power dams and steel mills. Too much, however, went for vast handouts.

Most of Brazil's state corporations were formed after the military seized power in 1964 and have served as a final roosting place for retired generals and colonels, giving them great political power. Measured by net worth, the 24 largest companies in Brazil are government corporations. Each has its cluster of subsidiaries that proliferated rapidly during the 1970s. Some of them are world-class industrial corporations whose business was avidly sought by big foreign banks that lent them roughly $60 billion over the past decade.

While some are highly efficient at major undertakings like iron mining and dam building, these state companies, insulated from market forces, often do what they do at horrendous costs. Petrobras, the state oil corporation, indulges in politically motivated payroll padding, poor supervision and politically motivated contracting. Thus, in spite of Brazil's relatively low wage rates, Petrobras incurs offshore production costs higher than they would be anywhere else.

Today, therefore, most of these state companies are broke, owing billions of dollars in back debts to banks, contractors and suppliers. Also, these public enterprises served as fronts for central government borrowing abroad. Access to seemingly limitless foreign credit made them immune, for a while, to cash-flow problems generated by overstaffing, posh fringe benefits and grandiose investment ambitions.

The proper weapon for ending such waste would have been the imposition of efficiency measures on the state corporations. But that would have involved politically painful payroll-cutting. So Antonio Delfim Netto, Brazil's minister of planning, decided to gamble. In 1979 the owlish, fast-talking former economics professor launched a New Economic Policy to "fight inflation with growth."

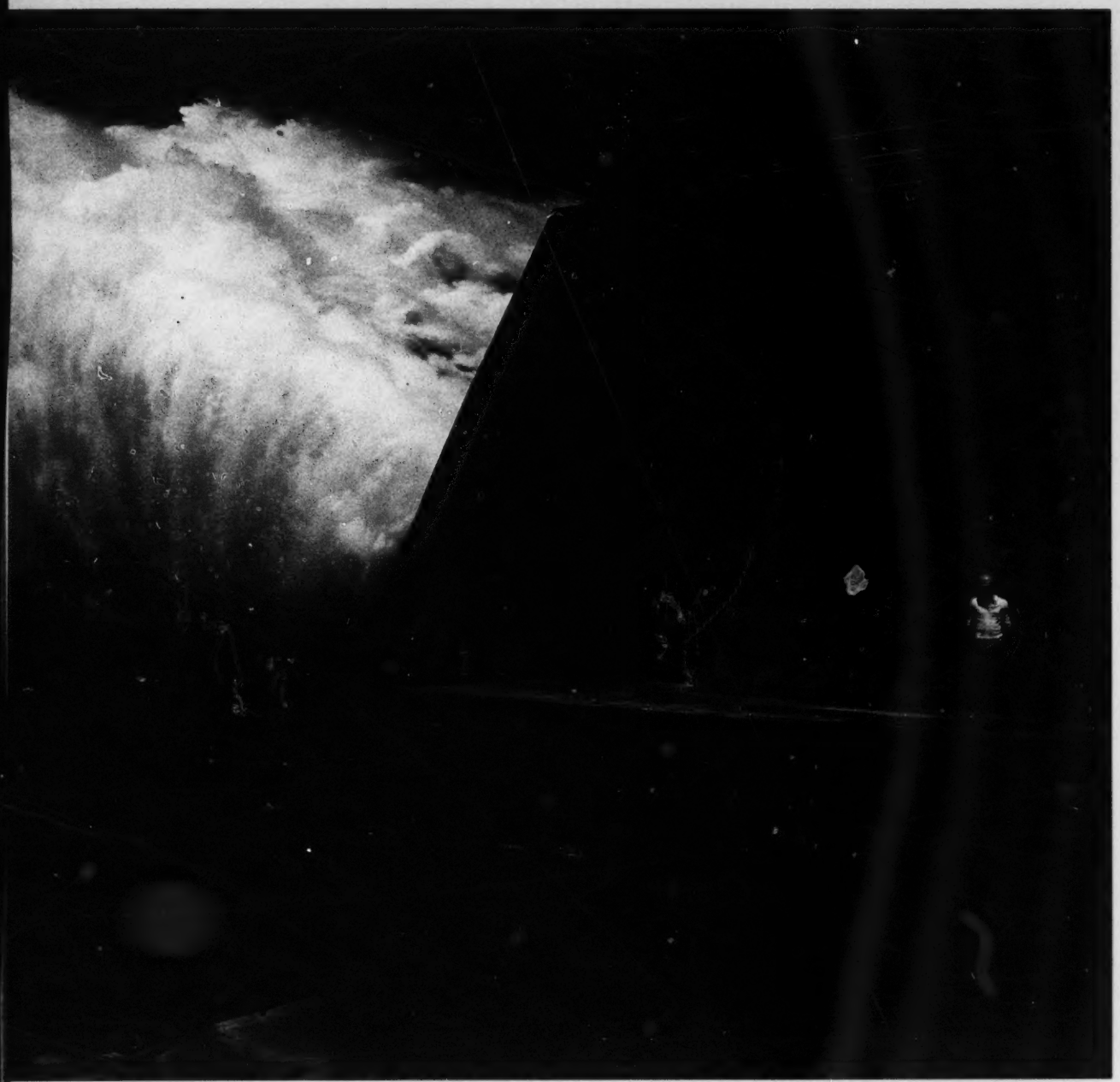
First, he announced that inflation could be beaten by a big harvest. So he hugely expanded rural credit, lending to farmers at interest rates barely one-fourth the inflation rate. What happened? Many of the farmers took the cheap money and put it out at high money market interest rates. According to a World Bank report, the acreage financed was from 30% to 100% greater than the area harvested for the main crops—soybeans, wheat, coffee and sugar.

Next, Delfim approved an "incomes policy" that pegged wage increases above inflation, already approaching 100%. Thus, instead of slowing inflation, indexing speeded it up. Delfim had turned Brazil's famous indexing system into a monster that nobody could control.

Private business could deal to a degree with rising labor costs by laying people off. But the state corporations—absorbing nearly one-third of the national product—couldn't lay people off. Doing so would lead to great unemployment and economic discontent. So the state companies continued to honor workers' "acquired rights," such as 16 monthly salaries for 11 months' work, retirement as early as age 50, plus free or subsidized housing, health care, supermarkets and personal loans.

"Just try to fire people or stop paying them 16 monthly salaries a year," says the president of one of the big state electric utilities. "You can't do it. We have strong unions in this company. They go to court to defend their acquired rights and they win. Overtime pay also becomes an acquired right, even if nobody works overtime."

Unable to levy enough taxes to pay the losses of this and other government spending, the government resorted to borrowing more at home and abroad. Government domestic borrowing was squeezing credit so severely that public and private companies couldn't meet their payrolls. It was a genuine crowding out of private credit.



To get around the shortage of credit, Delfim told private companies to borrow abroad, in dollars. This drove them into the friendly arms of foreign bankers, whose own coffers were swollen with Arab petrodollars. To make things easier, Delfim prefixed the exchange rate a year ahead of time at less than half the rate of inflation. A few years ago he described to FORBES the way things worked:

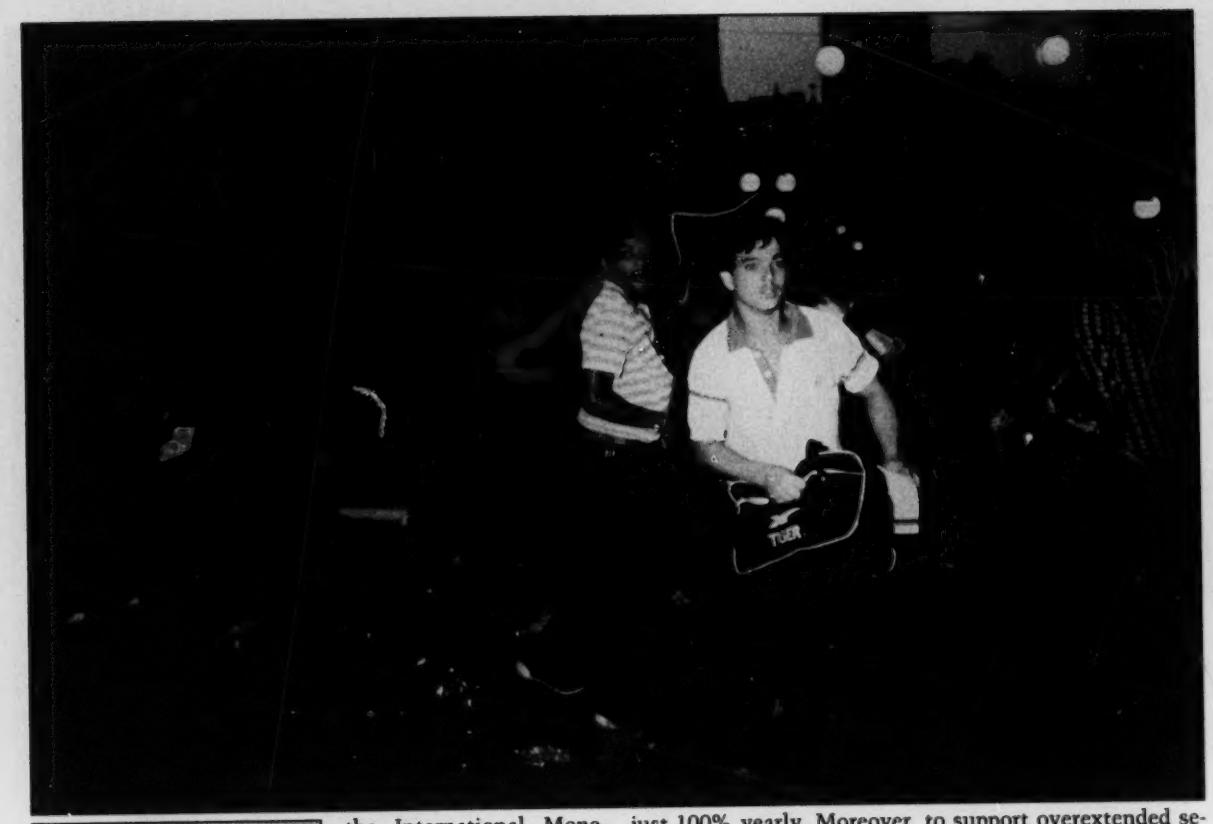
"Until now, what has been done is simply to get a foreign loan, change the dollars into cruzeiros and use this loan domestically to create money that could be spent."

Of course, he promised to change all that, and did. By steeply devaluing the cruzeiro he stopped the game of borrowing abroad by private business, but he also made it almost impossible for private businessmen to service their foreign loans.

So Brazil is hooked on credit but cannot carry its expensive habit any further. Put it this way: Not without a certain cynicism, knowing in the long run they could not service so much debt, the Brazilians succeeded in getting foreign banks to help finance their welfare state. Now, bereft of this questionable largess, with no net new foreign loans coming in, Brazil resorts even more desperately to the printing press. Inflation spins crazily out of control.

Again, the world has been here before, and the precedent is frightening. It was described in 1923 by Lord d'Abernon, the British ambassador to Berlin during the German hyperinflation: "In the whole course of history, no dog has run after its own tail with the speed of the Reichsbank. The discredit they throw on their own notes increases even faster than the volume of the notes in circulation. The effect is greater than the cause; the tail goes faster than the dog." Just substitute Brazil for Germany, and you have it.

To stop this long-ago tail-chasing, measures were developed by the League of Nations that closely resemble what



Recent street scene in São Paulo

A young secretary with an unemployed husband explains why the couple quit São Paulo for the remote countryside: "There's going to be an explosion. People can't live on what they earn."

the International Monetary Fund is trying to do today; that is, monitoring drastic internal measures in order to curb the government deficit. Thus neither the disease nor the medicine is new.

Under prodding from the League of Nations, independent central banks were formed in most of the inflation-ridden countries, and the new central banks abruptly stopped printing money and lending to the government. Unable to borrow, the government had to fire. In 1922, after the value of its currency declined by about 90% in eight months, Austria undertook to fire 100,000 government employees. In 1923-24 Germany fired 230,000 government employees.

Note this: It was drastic domestic measures that stopped inflation in the 1920s, not the kind of outside help Brazil is seeking. At this point Brazil is not yet desperate enough to sacrifice state capitalism, and part of the huge bureaucracy it has spawned, to put its finances in order. So the money chaos gets worse.

For example, on Monday, Oct. 17, Brazil's Central Bank auctioned 1 trillion cruzeiros (U.S.: $1.25 billion) in dollar-indexed treasury bonds. The issue was equal to one-fourth of Brazil's whole high-power money supply. It was eagerly grabbed by brokerage houses and small and medium-size banks that planned to retail them to their customers. The new bills were attractive to investors: interest, pegged to inflation and devaluation, was 250% to 300% yearly. And the government turns around and lends to the farmers at just 100% yearly. Moreover, to support overextended securities dealers, the central bank had to subsidize loans to them so they could hold the unsold treasury bills in their portfolios. Is there any wonder that Brazil is on the verge of total monetary collapse?

But, again, Americans would be wise to avoid complacency. The same thing has happened here. Farmers borrowing at subsidized rates and putting the proceeds into money market funds; middle-class people getting government-subsidized mortgages; autoworkers helped to big wage boosts by quotas on competitive Japanese imports. Americans need only think back to the height of their own inflationary frenzy in 1980 and 1981, when collectibles, condominiums and commodities were considered prime investments. Says a prominent Brazilian economist: "Today the private sector has stopped investing in production in order to invest in financial speculation."

Or, listen to this and shudder: "My regular customers have disappeared, but business still is pretty good," says a gentleman's tailor in a middle-class São Paulo neighborhood. "The middle class can't afford made-to-order suits anymore, but men who work in banks and brokerage houses now are ordering five or six at a time."

Among those who have profited most in this inflationary environment in Brazil are businessmen whose companies have declared *concordata* *(see box, p. 180)*. This is a Chapter 11-type proceeding to avoid bankruptcy, which suspends interest payments for two years while freezing cruzeiro debt at nominal levels and converting dollar debt into cruzeiros. *Concordata* has proved both profitable and popular. Some of Brazil's leading companies have joined the great surge of court petitions in 1983. Inflation, quite obviously, does nothing to improve business morality.

Fortunately, the U.S. seems to have turned off the path that leads to hyperinflation. But Americans will recognize the symptoms as described in the classic study of the great

Survival over conscience

What's it like doing business in an economy where inflation is accelerating almost out of control and where the government is trying desperately to apply the brakes? What do you do? You survive as best you can. Listen to the plaints of a well-known São Paulo business executive:

"My company got into trouble because commodity prices froze on our products in 1980-81, while inflation doubled our costs each year. I tried to stay in business by borrowing money until prices would recover. I spent two-thirds of my time trying to get more loans. By early 1982 I realized I never would be able to pay my debts and a *concordata* would be necessary."

Concordata, as our story explains, is a relatively gentle form of Chapter 11 that enables Brazilian companies to evade debt burdens while staying in business.

The businessman sighs: "We have an old family business, and taking a decision like this involved serious problems of conscience."

In the end, survival won out over conscience. The businessman continues: "But once I decided, I borrowed as much as I could, in addition to what I already owed, to buy all the new machinery I needed to operate my business efficiently during the *concordata*. When I didn't need any more credit and was in a strong bargaining position, I called in my creditors. Banks held nine-tenths of my debt and suppliers the rest, so I paid off my suppliers so our business could continue running normally.

"Ten months ago we were broke, but today I have $1 million in Brazilian treasury bills, earning fabulous profits and generating 30% of our cash flow without having to lift a finger. Meanwhile, the price of my company's stock has tripled, as has the price of other big companies' that declared *concordata*."

So attractive is *concordata* that many Brazilians have decided it is a sensible way to deal with the nation's foreign debt. They may be right. Since we no longer have debtors' prisons and warships are no longer considered a valid instrument for collecting international debts, renegotiation and scaling down seem the only sensible way of dealing with what Brazil owes abroad. The problem is not to make it too easy or attractive, and to provide enough guarantees to prudent lenders that credit can flow again, more rationally.—N.G.

German inflation. It was written by the Italian member of the War Reparations Commission in Berlin, Costantino Bresciani-Turroni. A half-century ago he wrote: "The fluctuations of the mark caused a continual instability in the conditions of German production, an alternation of periods of feverish activity and periods of restraint and business crises. To every improvement [strengthening] of the mark there corresponded an increase of unemployment." Then, as now, fighting inflation was a painful process. Inflation leads to instability, but deflation leads to painful interruptions in the general prosperity. No government of modern times, no social system, has dealt successfully with the problem.

In this context, the world is asking a lot in expecting Brazil to stop inflation and honor her debts.

There's been a great deal of scurrying around recently to resolve the Brazilian situation with a minimum of pain. Just before the IMF-World Bank meetings in Washington in late September, Brazil's new central bank president, Affonso Celso Pastore, began roaming the earth, talking with bankers in Washington, New York, Toronto, Honolulu, Tokyo, Bahrain, London and Zurich. He is trying to hold together agreement "in principle" on a new $11 billion rescue package, including a $6.5 billion jumbo bank loan for 1983-84.

Make no mistake, though: The jumbo plan won't get the banks out; it will get them in deeper. In one grand gesture it would expand the banks' exposure to Brazil by 11%, which would swell Brazil's foreign debt past the $100 billion mark.

"Can we put together the biggest jumbo in history for one of the world's financially weakest economies?" asks an executive of a big New York bank, one of Brazil's leading creditors. Maybe. Maybe not.

To the extent that Brazil is trying to cooperate with the International Monetary Fund, it has subjected its society to severe stresses already. One of the main talking points of Brazilian officials with bankers and the IMF is that their tight monetary policies held growth of the primary money supply to "only" 91% over the past 12 months, while inflation was over 200%. Part of this contraction of available cash came less from tight monetary policy than the fact that smart people were repudiating the use of cruzeiros to store their wealth, moving instead into dollars and dollar-indexed government securities. The poorest people, those who use cash most, have been bearing the brunt of the monetary contraction.

For example, over the past year food prices rose 334%, with some staples—such as beans and potatoes—multiplying fourfold. Income and cash available went up nowhere near that fast. As well-tailored Brazilian bankers and officials discussed the Brazilian debt in Washington and New York, some Brazilians were going to great extremes to relieve the cash squeeze: Mobs were sacking supermarkets in slums on the outskirts of Rio de Janeiro and São Paulo and in small towns in the drought-wracked northeast.

In the U.S. "austerity" involves a few union givebacks, the elimination of some cushy government jobs and, maybe, difficulties for young couples in moving to larger dwelling quarters. In Brazil austerity means hunger. Not surprisingly, Brazilians are openly rebellious at the idea of indefinitely committing up to 5% of their national income, representing half their export earnings, to paying interest on the enormous debt already accumulated.

Who is to blame that U.S., European and Japanese banks allowed their loans to the Third World and Eastern Europe to expand to $400 billion, over $200 billion of that to three Latin American countries, Brazil, Mexico and Argentina? Easy to blame the bankers. Why did they push loans on countries, knowing in their heart of hearts the loans could never be serviced, let alone repaid?

Or you can blame the borrowers. The foreign money was cheap money, usually lent at rates below inflation, and it was capital that did not have to be squeezed out of their own threadbare economies. So they took all that was proffered and asked for more.

But there is another side to this: Over the past decade the international credit expansion sustained world growth

and development in the teeth of a tenfold increase in oil prices. It was the bankers who "recycled" the vast petrodollar surpluses and averted a crash in 1974 and again in 1979.

It was a risky business, but everyone had his favorite rationalization. The big borrowers believed that banks could not afford to stop lending to them because any suspension of credit would lead to a default, which would in turn lead to financial panic in the main lending countries. With remarkable symmetry, the banks felt that they could lend freely because they, too, were too big to be allowed to fail. Besides, the bulk of their deposits from Americans are federally guaranteed. Those guarantees calmed depositors as illusion fed on illusion. It is always that way in booms.

Changing dollars on the street in São João del Rei

Smart people are repudiating the use of cruzeiros to store their wealth, moving instead into dollars. The poorest people, those who use cash most, have been bearing the brunt of the monetary contraction.

However, blame is not the issue now. Between 1979 and 1982 Brazil borrowed an additional $24 billion from foreign banks but paid out interest of nearly $28 billion. That means Brazil was bleeding cash even though its international debt was rising.

Yet the charade goes on, a charade of capitalizing interest, rolling over loan installments and increasing credits until the developing nations' debt reaches $1 trillion or more and people can no longer pretend. In fact, people cannot pretend much longer. For one thing, Brazil cannot and will not really carry out the terms of the International Monetary Fund rescue plan.

Three times this year Brazil has promised to bring the inflation rate down, but it has gone up instead, and it is still going up. Three times Brazil's Congress rejected wage control legislation and passed a watered-down version only in November. How effective these controls will be remains to be seen.

What now? If the banks can put together the new loans, the main beneficiaries would be the nine big U.S. money center banks, which as a group have lent the equivalent of half their capital to Brazil.

If the loans are made and interest payments resumed, the biggest banks *(see table, p. 186)* would be able to breathe a little; they would be relieved of the obligation, under U.S. banking regulations, of subtracting Brazilian interest more than 90 days in arrears from current profits and, later, writing off bad loans as capital losses. Also, the big banks would earn immediate profits from front-end fees and commissions of $65 million to $100 million for their trouble in arranging the new jumbo.

Who is to bail out the big banks? The little banks. The U.S. regionals currently have much less loan exposure to Brazil and have resisted being pushed into the big banks' crowded lifeboat. Yet the pressure is on them to produce much of the new money Brazil needs. The regionals reluctantly are agreeing to join in the $6.5 billion Brazilian jumbo, essentially for political reasons, though many have warned the big banks that this will be the last time.

German and Japanese banks also are joining the rescue for political reasons, even though the banks have been writing off much more of their bad foreign loans more vigorously than their U.S. counterparts.

But even if all the reluctant contributors finally are lined up in a united front to save Brazil and themselves from immediate financial embarrassment, how long can this process continue? Brazil's annual interest bill already amounts to half its export earnings. How long could a company stay in business if half its revenues had to be used for interest payments? Not long.

Yet another voice from the 1920s: In his *Tract on Monetary Reform* (1923), John Maynard Keynes observed: "The active and working elements in no community, ancient or modern, will consent to hand over to the *rentier* or bondholding class more than a certain proportion of the fruits of their work." When debt burdens become intolerable, he added, the government resorts to repudiation or devaluation, which wiped out two-thirds of the French and all the German public debt in the 1920s.

Eventual default, therefore, is not a probability but an inevitability. Even if Brazil were a totalitarian state, it probably could not force enough austerity on its people to pay the international debts. But default can be managed. Look at the way the International Harvester and Chrysler situations were handled in the U.S. The important thing is that both companies were kept alive and eventually got enough fresh credit to stay in business. The losses, of course, are much greater in lending to foreign governments. So, many of the banks would have to look to their own central banks and their governments to bail them out—at a penalty, of course—on the grounds that while the banks did transgress, their transgressions got the world

Morgan Guaranty	1.7	43.8	3.9	446	3.2	53	Morgan Guaranty

Loan loss reserves and stockholders' equity as of 9/30/83; all other figures as of 12/31/82. *Sources: Bank data; Keefe, Bruyette & Woods; Institute for International Economics.*

through the petrocrisis and helped expand world trade.

A start has been made. Loan loss requirements are not yet set for new and rescheduled loans to countries in debt trouble. U.S. regulators also apparently are relaxing the legal lending limit—15% of capital to any one borrower—to accommodate banks in granting new loans to countries that cannot otherwise service their debts. A year ago federal authorities began requiring banks to report and deduct from profits all arrears in interest payments of more than 90 days. This grace period now is being stretched to six months. Also, all peso payments in escrow to the central banks of Mexico and Argentina, which don't have the dollars to pass these loan payments on to the banks, have been treated as current income by U.S. banks, with the blessing of federal regulators.

In deep

The weight of loans to Brazil on the balance sheets of these big U.S. banks—the largest private lenders to Brazil—is now distressingly close to the weight of their capital. Would their capital be wiped out if, as seems probable, Brazil stops paying? Probably not, since accountants and federal regulators would step in to control the bleeding so the big banks would survive. But will the banks be more careful next time?

These, of course, are only delaying actions.

There are plenty of proposed long-term solutions. Most suggest conversion of loans into long-term, low-interest debt administered by the World Bank, the IMF or some new international agency. An indirect bailout of this kind is seen as more elegant, and politically less controversial, than if the central banks were to buy the bad paper and pocket the loss on behalf of taxpayers.

One such proposal has come from MIT Professor Rudiger Dornbusch, which would tie a scaling down of foreign debt to a scaling down of the explosive government domestic debt. It would accompany both with a radical devaluation of the cruzeiro to induce Brazilian companies to export more. Dornbusch would convert Brazil's foreign debt into long-term, low-interest government bonds. The banks could hold or sell them. If sold, the bonds would fetch a price well below 100 cents on the dollar. This would involve the banks in major losses but would bolster their liquidity. Who would buy the bonds, even at a discount? Dornbusch cites New York City's experience. When the city was close to default, there was still a market for its outstanding bonds, albeit at a big discount.

Market forces already have begun to move in this direction with the establishment in London of an informal secondary market for loan paper. In this market, Brazilian loans sell at 60 cents on the dollar. The point is: The system almost certainly can absorb the shock. Loans to developing nations and Eastern Europe by the international banking community total $400 billion, with $135 billion of this from U.S. banks. But against this, U.S. banks have total assets of $2 trillion. They have annual profits of about $15 billion. If half their $80 billion in Latin American loans had to be written off over, say, ten years, with corresponding tax credits, bank profits would be severely reduced. But the banks would, as a group, remain solvent. Judging by the prices at which some leading bank stocks are currently selling, that possibility has already been partly discounted by the market.

The real issue is not bank profits but trade. The debts cannot all be collected, but they must be dealt with in a way that keeps credit flowing to finance trade and to finance genuinely productive enterprise. Terrifyingly large as the potential loan losses are, the money is gone, and the important thing now is to prevent the financial damage from savaging the real world of trade, employment and investment.

They hired the money, didn't they? Yes, but they can't pay the rent on it and never will be able to. Admission of that fact is the starting point for any solution to the crisis. ■

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